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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

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The Potential for Soviet Gold Sales

Summary

The USSR is facing a drop in hard currency earnings of $3-4 billion this year and another $2-3 billion in 1986 as a result of declining oil exports and a falling world oil price. Although Moscow has already begun to take steps to offset this revenue shortfall--including borrowing more in international financial markets and cutting back somewhat on hard currency imports--its short- and medium-term financial plan will almost certainly include some increase in gold sales over the low levels of recent years. [redacted] 25X1

We believe Moscow could sell as much as 300 tons of gold on the open market in 1986 without a major price reaction, and that there is scope to sell amounts over 300 tons if done judiciously in the futures market. It is also likely that direct sales of gold--currently a very small share of total Soviet sales--will grow in importance over the next several years, limited only by the market's increasing awareness of this practice. Thus, assuming Moscow brings all of its expertise to bear, and assuming an average price per ounce for gold in 1986 of $300, Moscow could earn about $3 billion in the open market, and perhaps another $1-1.5 billion using other marketing methods. We believe that concerted or repeated use of these methods would, however, eventually depress the price of gold in all the markets as word got around, limiting Moscow's room to maneuver. [redacted] 25X1

Gold is not the only product Moscow could sell to generate cash rapidly. Diamond sales, which reportedly are on the rise, could be a large hard currency earner. [redacted] the relatively high 25X1 price of some platinum-group metals might be an incentive for Moscow to increase those sales as well. Moscow is currently in a position of dominance in the world palladium market, for example. Moscow could also boost sales of other non-ferrous metals such as aluminum, nickel, and copper. [redacted] 25X1

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Introduction

Currently the USSR accounts for approximately one-fourth of annual world gold production and of the newly-mined gold moving in world trade. This memorandum considers the Soviet Union's ability to market increased amounts of gold in light of its hard currency earnings difficulties, as well as the likely market reaction to such a change in behavior. 25X1

Soviet Marketing Strategy

The Soviets have considerable flexibility with regard to gold sales. We estimate the USSR produces approximately 340 metric tons of gold annually, although for the past several years it has sold considerably less--under 100 tons per year (see figure 1). By adding the difference between production and sales to its stockpiles, the USSR has built up its reserves to about 2,800 tons. 25X1

Our analysis of Soviet hard currency balance-of-payments trends indicates that Moscow uses gold primarily as a financing mechanism rather than a trade commodity like oil. The Soviets generally sell more gold when they need a rapid infusion of cash, and less--even when prices are high--when they are in a good cashflow position. Thus, during the mid-1970s when the Soviets needed to finance large grain purchases, gold sales were high, while sales have been low in recent years as record oil sales to the West have obviated the need for extra cash. With the decline in oil export earnings this year, however, we expect gold sales to increase to 180 tons; about half the revenue, however, may go

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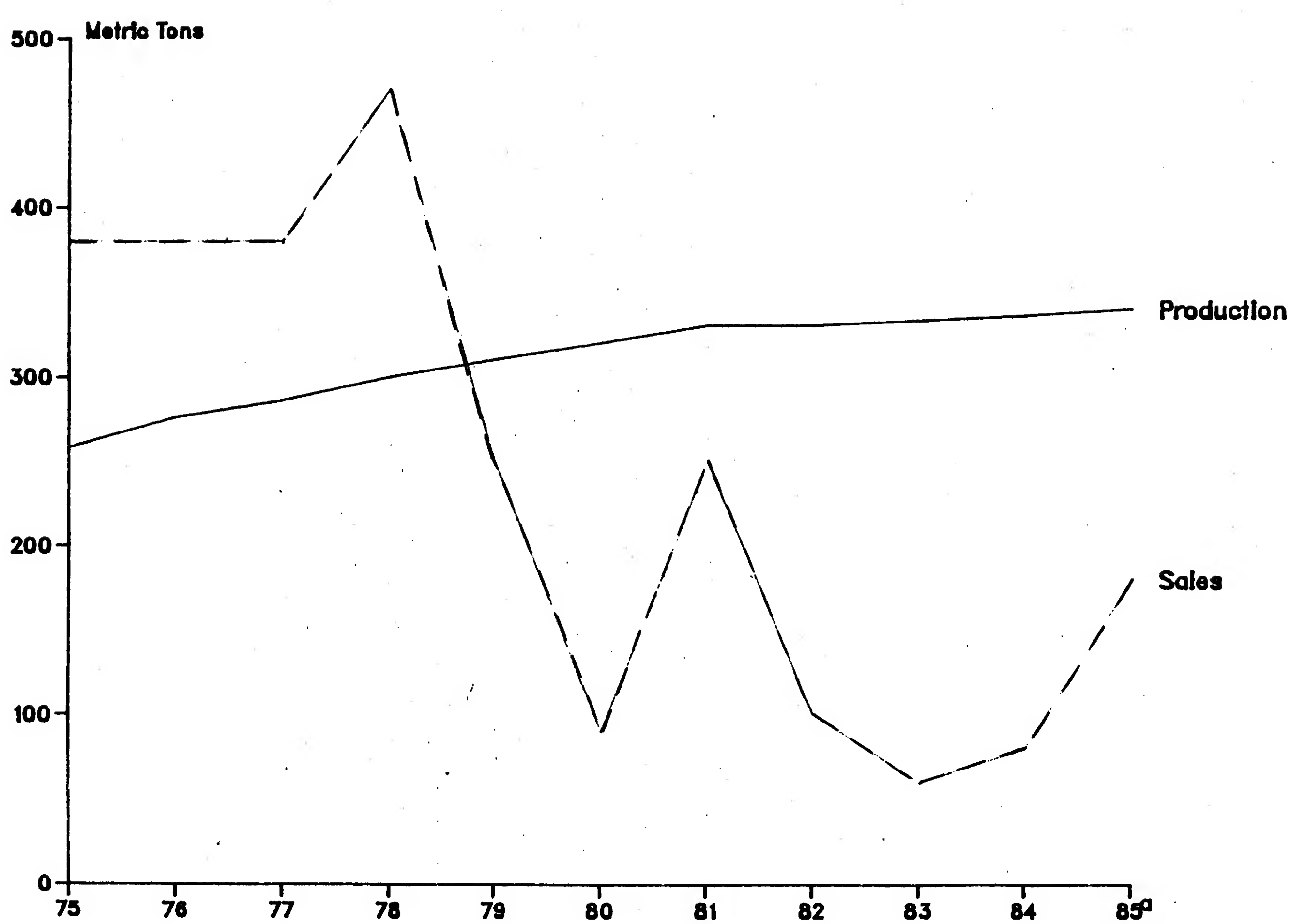
Soviet Gold Market Strategy



a The data for 1985 is estimated.

to offset the losses accruing from the bankruptcy of the Soviet-owned bank in Zurich. We believe a continued fall in oil earnings may well lead Moscow to resume even larger gold sales next year. [redacted] 25X1

Market specialists believe that Moscow could probably sell as much 300 tons of gold on the open or "physicals" market in 1986 without too much effect on the already soft price--if the sales are spread over the year and among all the geographic markets. [redacted] 25X1 the market watches the Kremlin's actions very closely and Moscow would need to be very cautious to increase its sales volume in an orderly and non-disruptive manner. Assuming the Soviets act shrewdly, however, and receive an average price of about $300 per ounce, Moscow could earn about $3 billion from gold sales in 1986. [redacted] 25X1

To avoid a substantial price drop on the open market, [redacted] 25X1 [redacted] the Soviets would turn to the futures markets to 25X1 sell any major quantities in excess of 300 tons. [redacted] 25X1 [redacted] Moscow can, and in fact already does, use the gold 25X1 futures market to speculate. (See boxed insert for a description of physicals and futures markets and how they operate.) With its cash-flow currently constrained, the USSR might commit to a sale in the futures market and then--although unusual in that market--actually deliver the gold and take the money. Increased sales in the futures market would be less likely to cause price ripples than straight market sales above 300 tons, because Moscow is

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Physicals Market vs Futures Market

The physicals market for any commodity usually involves actual exchanges of the commodity for money. The concept is similar to a consumer walking into a store and buying a stereo for cash. However, when a commodity is fungible--one unit of it is indistinguishable from another as is the case with corn--the buyer frequently deals with a broker or other middle-man and may never be able to identify the actual producer of the item. Although Soviet gold differs slightly from that of other major producers--it is .9999% pure (often called 'four nines pure') as opposed to South Africa's .9995% pure ore ('three nines five')--the difference is negligible when gold is bought for investment purposes, and gold is considered to be a fungible commodity. [redacted] 25X1

Four factors make it especially difficult to track Soviet gold through the physicals market:

- o Much of it is already sitting in various reserve depositories in different countries, so that when four nines gold appears on the market one cannot be certain it came from the USSR.
- o South African gold can be purified so it becomes four nines pure, or Soviet gold melted down and the markings changed.
- o Gold is traded through many large banks and brokerage houses in this country and Western Europe and, in the last few years, is beginning to be traded in Japan as well.
- o Direct sales of gold without recourse to a market are not uncommon, especially when the buyer is an industrial end-user rather than an investor. [redacted] 25X1

Futures markets were conceived originally as a way of guaranteeing a supply of a needed commodity months in advance and locking in a price. Thus, a jeweler might contract in the futures market for half a ton of gold six months from now, knowing that that is when he will next need to replenish his supply. Today, many people and institutions play the futures market purely for speculation, buying forward at today's price if they believe the price is going to rise and selling if they think it will fall. Only infrequently do users of these markets actually take possession of the commodity in question. Most often, they wait till the price has moved in their direction--or the contract is nearly due-- and then reverse their action (buy or sell). [redacted] 25X1

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Gold futures are traded in London on the International Financial Futures Exchange (IFF), in New York at the Commodity Exchange (COMEX), and in Chicago at the International Metals Market (IMM). We believe that imprudent speculation in the gold futures market may have led to the bankruptcy earlier this year of the Soviet-owned bank in Zurich. 25X1

END BOXED TEXT

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generally a large player in the futures market. [redacted] 25X1

In addition to marketing gold on the physicals and futures markets, [redacted] Moscow increasing its direct 25X1 bilateral gold sales. There have been unconfirmed reports of Soviet gold being shipped into Japan, for example. Direct sales generally take place at a mutually acceptable price and without any record in the market that the transaction took place. Although these sales usually show up in the partner country's annual foreign trade data--the Soviets do not report gold sales--the market would not be aware of the trade in a timely fashion. [redacted] 25X1

Market Reaction and Impact on Other Sellers

By using the physicals market, the futures markets, and direct bilateral sales, the Soviets could probably sell a total of 400-500 tons in 1986 without causing a major sustained price decline, but would have difficulty repeating this. Annual demand for gold, both for industrial uses and for investment /stockpiling, is fairly constant. Because the market watches the Kremlin closely for hints of action and is already weakened by low inflation, it would probably be susceptible to the effects of a sustained increase in supply. Thus, we believe, concerted or repeated use of these methods would eventually cause a price adjustment in all the gold markets, as word got around that Moscow was selling on a continual basis. [redacted] 25X1

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Any Soviet move in the market which caused the price to fall would adversely affect South Africa--the world's largest seller with estimated sales averaging 640 metric tons annually. Although Moscow has the freedom to vary its gold sales to meet short-term cash needs, Pretoria has less leeway because it sells a much higher proportion of its annual production (see figure 2). Gold is South Africa's big hard currency earner, accounting for roughly half of total export income. Thus, there is probably little South Africa can do in response to a Soviet move which depresses prices--a sales boycott would only benefit Moscow, and undercutting Soviet prices in other markets (diamonds, precious metals) would hurt Pretoria as much as Moscow. [redacted] 25X1

From a political point of view, some gold buyers may find Soviet gold or other products preferable to South African in light of negative Western reactions to Pretoria's racial policies. Moreover, although South Africa maintains sizable gold stocks to insure its continued ability to supply the market, some buyers may perceive Pretoria as an unreliable supplier due to worker unrest, and may therefore prefer dealing with the Soviet Union. [redacted] 25X1

<u>Related Issues</u>

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gold is not the only product Moscow could sell rapidly to generate cash. Diamonds, in particular, could be a large hard currency earner. The USSR last published diamond production and sales data in 1980, at which time hard currency earnings from diamond sales were approximately $1 billion--making diamonds one

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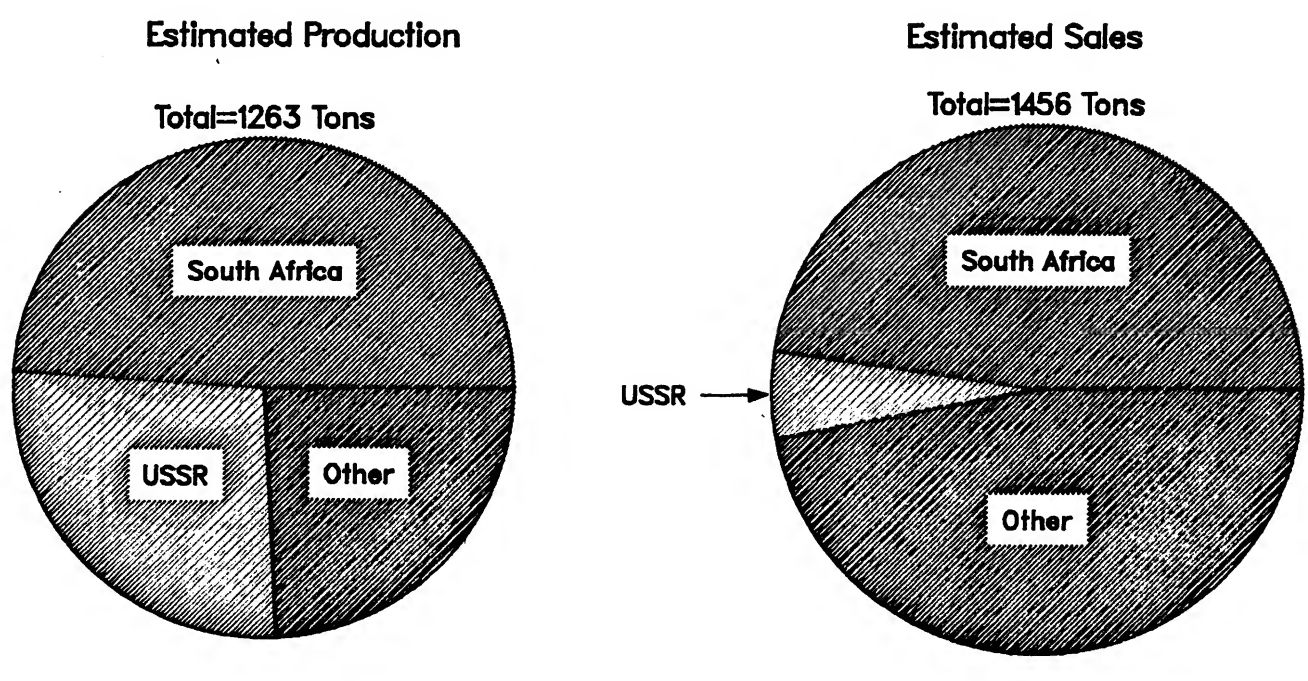
USSR-South Africa: Gold Market Relationship, 1984



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of Moscow's top three hard currency commodities. In 1984 [redacted] noted evidence of discord between South Africa and the USSR over diamond sales. Western diamond traders reported being invited to Moscow to examine and purchase Soviet diamond output in contravention of the South African and Soviet diamond cartel's rules. Possibly reflecting this activity, [redacted] Soviet yearly hard currency earnings from diamond sales may have doubled during 1981-85--to about $2 billion in 1985--and [redacted] such earnings will likely continue to grow, with or without the cartel's agreement. [redacted] the relatively high price of platinum-group metals in the current market might be an incentive for Moscow to increase its sales of such metals. The USSR and South Africa mine over 90 percent of the world's platinum-group metals, and Moscow is currently in a position of dominance in the world palladium market. The USSR earned approximately half a billion dollars from sales of platinum-group metals in 1984 and about the same in 1985. The market has some potential to increase in 1986 as automobile pollution controls, which utilize platinum group metals, are required in more Western countries. [redacted] even in the face of depressed markets, Moscow also could try to boost sales of nonferrous metals such as aluminum (with Soviet sales of about $308 million in 1984), nickel ($211 million), and copper ($55 million). [redacted]

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